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Canada Ranks Low in R&D Spending, Subsidies Not the Answer: C.D. Howe Institute

Toronto, Nov.19 — Canada's approach to targeting generous subsidies for research and development (R&D), while also imposing relatively high taxes on the fruits of innovative activity and entrepreneurship, is misguided, says a study released today by the C.D. Howe Institute. The Commentary, *Giving with One Hand, Taking Away with the Other*, is written by Kenneth J. McKenzie, EnCana Scholar in Public Policy at the C.D. Howe Institute and professor of economics, University of Calgary. If the goal is to generate more R&D activity and the innovative investment that surrounds it, says McKenzie, an improved tax environment for business investment, rather than larger R&D subsidies, would be the correct policy prescription.

Recent research suggests that Canada's tax system acts as a drag on innovative activity. In effect, the Canadian approach has been to give with one hand, by providing generous tax credits targeted at R&D, and to take with the other, by imposing high taxes on the fruits of innovative activity and entrepreneurship.

Canada's tax treatment of business spending on R&D does appear to be internationally competitive. The cornerstone is a 20 percent federal tax credit — for small businesses it is 35 percent — which most provinces top up with a further R&D credit of 10 or 15 percent. The result is "one of the most generous scientific research and experimental development tax incentive regimes in the world," according to the federal Department of Finance. And among industrialized countries, in terms of direct tax subsidies per US$1 of R&D expenditures, Canada is indeed near the top.

Despite this support, Canada ranks low in aggregate R&D intensity — that is, R&D as a percentage of gross domestic product. On this measure, business R&D in

Canada in 2004 was 1.07 percent — below the average of 1.53 percent for OECD member countries and well below that of other Group of Seven major industrialized economies except Italy. Canada also compares poorly to Sweden, for example, which provides few direct subsidies for R&D (but has a very competitive production tax regime): business R&D as a percentage of GDP in Sweden is about double that in Canada.

What to do? Federal and provincial governments should work toward increasing the competitiveness of Canada's overall tax regime as it affects production costs. Such a policy could involve reductions in statutory tax rates and structural changes in the tax system. One possibility would be to move toward a business value tax at the provincial level, perhaps coupled with the introduction of tax prepaid savings plans for individuals.

Other changes would be to reconfigure the tax depreciation system to make it more in line with economic depreciation; introducing last-in, first-out inventory accounting for tax purposes would also reduce effective tax rates on investment. Taken together, these initiatives would lower the tax rate on production and free up domestic savings for investment in innovative activities, spurring investment, innovation, and entrepreneurship.

The study, *Giving with One Hand, Taking Away with the Other*, by Kenneth J. McKenzie, is available at www.cdhowe.org.

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Giving with One Hand, Taking Away with the Other. C.D. Howe Institute Commentary No. 240, by Kenneth J. McKenzie (October 2006). 17 pp; $12.00 (prepaid, plus postage & handling and GST — please contact the Institute for details). ISBN 0-88806-697-X.

Copies are available from: Renouf Publishing Company Limited, 5369 Canotek Road, Ottawa, Ontario K1J 9J3; or directly from the C.D. Howe Institute, 67 Yonge St., Suite 300, Toronto, Ontario M5E 1J8. The full text of this publication is also available from the Institute's website at www.cdhowe.org.